

## **Investing 101 Chapter 7 - Portfolio Management. Portfolio Construction Risk Management & Diversification**

The main objective of creating and managing a portfolio of stocks is long term generational wealth creation. All the guiding principles and tenets for constructing and maintaining a portfolio will be based on this objective.

That rests on a bedrock of a basic principle, that all companies we choose have to be fundamentally strong businesses and do well for at least a decade. If businesses don't meet that criteria they should not be included in the portfolio.

Once we identify them, the key component is to balance reward and growth with risk and diversification.

Why do we need to diversify?

Simply, because even as companies do exceedingly well in their lifetime, they are subject to market movements, which do not show any linear correlation at many times with its operational and financial performance. Sometimes the rewards are very early, which means they get overpriced. Sometimes sentiment is so negative that rewards take forever. Many times companies stumble and don't achieve quarterly goals.

Benjamin Graham, Warren Buffet's Guru...

"In the short run, the market is a voting machine (reflecting popularity/sentiment), but in the long run, it is a weighing machine (reflecting true intrinsic value)".

During the chapters that we have gone through in this course, we have emphasized a lot of aspects of fundamental investing, valuations, the various categories of stocks, analysis of their financials, and an analysis of the company strategies.

We look at a portfolio, which has some of these excellent companies and see how they shape the portfolio.

### **Basic rules:**

1. Defining the portfolio and objective.
2. Annual and 10 year returns.
3. Risk capacity
4. Company category, sector and investment thesis identification  
United Healthcare, Novo Nordisk, and CVS are sometimes classified under healthcare: Nothing could be further from the truth. Similarly "Tech" is not a real category, and lumping Apple, Credo, Dell, and Nvidia under "Tech" is a big mistake. This is a quarter of the battle won.
5. Rules for portfolio allocation and re-balancing - most effective tool for risk management.
6. Risk mitigation tools.

## 1. **Defining the portfolio**

The Fountainhead portfolio is a growth oriented portfolio with a focus on technology, artificial intelligence, and semiconductors.

Its goal is to only include high quality companies with proven tech records of strong secular growth, with good margins, and cash flow,

Each company should have all or at least a strong combination of

- a) Competitive advantages - product, pricing and branding power.
- b) Market leadership
- c) Secular growth prospects for the next 3-5 years.
- d) Honest and principled management looking out for their stakeholders.
- e) The ability to compound.

Portfolio inclusion is extremely important, and to be sure 30% of the portfolio may not perform, but if the correct amount of due diligence is done, our risks are reduced substantially.

After going through the checklist, it should be priced at a discount and have a margin of safety.

The basis is as outlined in chapter 1 - BUFFET/LYNCH'S FUNDAMENTAL PRINCIPLES

## 2. **Returns for each stock and category**

How do I go about objective identification of a targeted return? The process involves using the S&P 500 as a benchmark for the market return and the higher or lower return expected from the individual company based on its fundamentals. Each stock is assigned a P/E, PEG, P/S and P/S G on average earnings and sales three years out. The same "intrinsic value" or perceived fair value is then used as a range for the category for consistency and rebalancing. This has become especially important because the returns for hyperscaler and M-7 stalwarts were largely secondary to their defensive nature as stalwarts with deep, deep moats. However, with the large amounts of Capex, and burgeoning debt dominating their business strategy, returns are now less certain and one will have to balance the oncoming risk.

## 3. **Risk capacity**

Given our focus on technology, AI, and other growth companies, our business and valuation risk is higher than the broad market. To compensate for the higher risk we need higher returns.

Within each stock and category I also value business risk and valuation risk and balance both criteria. I will classify risk as business and valuation risk. For the most part, risks are usually company and industry specific, however given the rapid advancements from AI, risks have compounded, which means there are sweeping changes to industries prone to disruption. See my reference to the M-7 returns in point 2. I believe the shifting narratives will change a whole lot of risk assessments and this is a key factor in portfolio rebalancing. It ties into our objective of requiring a higher margin of safety and a deeper discount because of the additional risk.

## 4. **Categories**

Within the portfolio, I have made categories and investment thesis to provide for diversification and balancing. The categories are from chapter 4, and are crucial to maintain the long term health of your portfolio. Know what you own and try to foresee where it will be in the

next 5-10 years. Stocks shift categories, we will always re-asses every year, and sooner if needed.

## 5. **Portfolio allocation and balancing**

This should be a quarterly objective.

Importantly the narrative will shape some of the portfolio allocation as long as it doesn't clash with the first rule of company selection. For example, I won't switch to a mediocre "value trap" defensive just because the market has shifted. Similarly, I will abandon my plan for a defensive stalwart position in 2026, if the stalwarts become indebted and cash guzzlers.

## 6. **Risk mitigation tools**

This is a key part of portfolio management. There was a time when a large part of my portfolio was dominated by "Buy and Hold" stalwarts, which you didn't disturb and let compounding take care of the portfolio.

However, given the emphasis on tech and the volatility in our portfolio, we cannot let it be a pure buy and hold, there will always be stages where we book profits and stop losses. This is not timing the market, it is purely risk mitigation.

The most important part of risk management is sticking to the rules and not having second thoughts, because of market or other developments.

In the previous class I discussed options, and stop losses and we will go through some of these in detail, from the portfolio spreadsheet. Please spend time on the principles and the mechanics, if you would, to use them as insurance tools.

### **Covered call options:**

I sell calls on stocks that I own. When you sell a call option you give the buyer the right to buy the share at a fixed price on a certain date. SELLING CALL IS AN OBLIGATION TO SELL. For that you collect a premium, which means that you don't expect the share to go beyond that price and you're OK to part with your shares. If it doesn't you just collect the premium. We will go over the Nvidia example.

DO NOT SELL CALLS IF YOU DON'T OWN SHARES - SELLING NAKED CALLS IS THE RISKIEST TRADE IN THE MARKET.

### **Profit taking:**

Very useful when stocks have gained a tremendous amount in a short period of time, exceeding your targeted return. The secular growth and AI category stocks usually attract profit taking. I usually trade about 25% of the more volatile stocks, when given the opportunity or if they reach a certain target.

### **Stop losses limits:**

A stop loss limit is a trade order entered in advance, at a price, beyond which you don't want to bear the loss. A must have, especially for those who don't use options. One of the most important rules of a stop loss limit is to increase it when the stock has gone up too fast...this protects your profits. For example, if your stock has doubled you don't put a stop loss at your purchase price or below, you put it at 20% lower than the current price. That way you still walk

away with a 75% gain even if the stop loss is triggered. It worked for me in AppLovin, when I didn't catch the top but sold with a still considerable gain of almost 4x my investment. but not in Duolingo. In the case of Duolingo I averaged lower after a 60% drop from the high, not realizing that growth had slowed considerably. Many times the extraordinary upward gains are an anomaly and should be treated as such.

**Buying Put options:**

Buying a put option gives you a right to sell at a certain price, which works as a stop loss limit. You have to pay the premium but that premium should be treated like an insurance premium the same way you protect your car or your home. It's well worth it, because tech and other high growth stocks are volatile and you really don't want to be caught standing without protection. For example, I have put options on Nvidia at \$170.

**Collars:**

A collar is an effective way of capping your potential gains and limiting your potential losses. You take positions on both sides. The mechanics of the trade are selling a covered call (of a stock you own) and using the premium to buy put options. I'll walk you through an existing collar that I have on Nvidia.